Internal Revenue Service

memorandum

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Brl:BDBurns

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to: District Director, Greensboro

from: Chief, Branch 1
Associate Chief Counsel (International) CC:INTL:1

subject: Request for Technical Assistance Regarding I.R.C §§ 482, 7872, 1441 and 1442

Your request for technical assistance regarding I.R.C. §§ 482, 7872, 1441, and 1442, originally addressed to the Associate Chief Counsel (Technical), has been referred to this office for response.

FACTS

During a classification detail, you discovered that a number of foreign owned U.S. corporations within your district were showing net operating losses with their continued operations being funded by non-interest bearing loans from their controlling foreign shareholders. Generally, the U.S. corporations had been in business for a short period of time, four years or less, and the accumulated E&P of most of the companies was negative. In all of the instances, more than 50% of the stock of the U.S. entity was owned by a single foreign individual or corporation.

ISSUES

1. Whether interest can be imputed on an interest-free or below-market interest loan by a foreign shareholder to a controlled U.S. corporation under I.R.C. §§ 482 and 7872.

2. If interest can be imputed on interest-free or below-market interest loans made by controlling foreign shareholders to their U.S. corporations, and if the interest so imputed is determined not to be connected with a U.S. trade or business as defined by I.R.C. § 871(a)(1)(A), must tax be withheld pursuant to I.R.C. §§ 1441 and 1442 on the imputed interest.

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DISCUSSION

Interest-free or below-market interest rate loans are the economic equivalent of loans bearing a market rate of interest with separate payments being made by the lender to the borrower to fund the payment of interest by the borrower. Interest-free and below-market interest loan transactions effectively compress two transactions into one and have historically resulted in aberrational tax treatment. In some instances the taxpayers have been able to utilize the aberrational treatment to circumvent other rules of taxation. In the classic situation of an interest-free loan by a corporation to its controlling shareholder, the courts consistently held that an individual stockholder did not realize dividend income from a below-market interest loan because, as a matter of economics, that income would be offset by a deduction for imputed interest. See, J.Simpson Dean v. Commissioner, 35 TC 1083 (1961). On the other side, the corporate lender was held not to have interest income unless it could be demonstrated that the borrower had used the proceeds in an income producing activity. See, Tennessee-Arkansas Gravel Co. v. Commissioner, 112 F2d 508, (6th Cir., 1940).

The prohibition against creating income has now been totally rejected. See, Latham Park Manor v. Commissioner, 69 TC 199, 1977. Consequently, if the shareholder-borrower is an organization, trade or business so that 482 is applicable, interest income can be imputed to the lending corporation. In theory, section 61 should apply to impute interest income to the lender in a situation where the shareholder-borrower is not a separate organization, trade or business. If the adjustment is made under section 482, a correlative adjustment would be necessary to allow the borrower an interest expense. Unless the J. Simpson Dean decision can be reversed, this would not be an answer to the problem since we still cannot impute dividend income to the borrower to offset the correlative imputed interest expense adjustment.

In comparison, if the loan had provided for an arm's length interest rate which was paid by the borrower with funds it received in the form of a dividend from the corporation, the borrower's deduction for interest would generally have offset the dividend income and resulted in no tax change to the borrower. The lender would have had interest income which would have been taxed at the corporate level since it could not be offset by the dividend payment.

The following hypothetical illustrates and quantifies the differences between the two transactions. For purposes of simplifying the discussions, we have used pre-1986 Tax Reform Act tax rates. Assume that corporations X and Y are both in the 46% tax bracket while their respective 100% shareholders A & B are each in a 50% tax bracket. X makes a demand loan to A of $100,000 at an arm's length interest rate of 10%. Y also loans B $100,000 but with no interest. Corporation X makes a $10,000 dividend distribution during the year while Y makes no formal dividend distribution. Shareholder A's dividend of $10,000 is completely offset by a $10,000 interest deduction. Corporation X realizes $10,000 of interest income on which it pays a tax of $4,600. Corporation X's earnings and profits are reduced by the $10,000 dividend and increased by the $5,400 of net income resulting in a net decrease of $4,600.

In the case of Y and B, neither realized any taxable income and $4,600 of tax was irretrievably lost. Since Y's E&P was not reduced for a $10,000 dividend, there remains a deferred potential for tax on a subsequent distribution of $5,000. X's E&P was reduced by $10,000 but was increased by $5,400. The net deferred tax potential in X is thus only $2,700 instead of $5,000. Note that the positions of X and A are exactly the same as if X had lent $100,000 at 10% to an unrelated third party while A had borrowed $100,000 at 10% from an unrelated party with X paying a dividend of $10,000 to A in order to help A pay the interest on the third party loan.

Section 7872 was enacted as part of the Deficit Reduction Act of 1984 in order to deal with situations such as the loan to shareholders. In this regard, section 7872 was intended to supplement, and to some extent, supplant section 482. As will be discussed below, not all interest-free or below-market loans give rise to situations where circumvention of other tax rules are possible. Consequently, in some situations, the result reached utilizing sections 61 and 482 should be the same as that which will be reached under section 7872.

Section 482 provides that the Secretary may distribute, apportion, or allocate gross income, deductions, credits, or allowances between two or more controlled organizations, trades or businesses in order to prevent evasion of taxes or clearly to reflect the income of any of such organizations, trades, or businesses. Treas. Reg. § 1.482-2(a)(1) specifically provides for appropriate allocations to reflect an arm's length interest rate where one member of controlled group of entities makes a loan or advance to another member of the controlled group for other than an arm's length interest rate. Unlike section 7872, section 482 applies to overcharges as well as undercharges of interest between related parties. As you noted in your memorandum, Treas. Reg. § 1.482-2(a)(3) provides that the interest allocation provisions do not apply to alleged indebtedness which is in fact a contribution to capital or dividend distribution.

Section 7872(a) provides that the below-market gift and demand loans are treated as (A) transferred from the lender to the borrower, and (B) retransferred by the borrower to the lender as interest. The transfer and retransfer is deemed to take place on the last day of the calendar year in which the transaction occurred. For non-gift term loans, section 7872(b) provides that the borrower is to be treated as having received cash on the date the loan was made to the extent that the amount loaned exceeds the value of all payments required to be made under the terms of the loan. The excess cash deemed to have been received is then treated as original issue discount and recognized as income by the borrower over the term of the loan.

Section 7872(c) lists six categories of below-market loans to which the provision applies. For our purposes, we need only be concerned with corporation-shareholder loans which are defined as "any below-market loans directly or indirectly between a corporation and any shareholder of such corporation" and tax avoidance loans which are defined as "any below-market loan one of the principal purposes of the interest arrangements of which is the avoidance of any federal tax".

Literally, foreign shareholder to domestic corporation loans are within the definition of corporation-shareholder loans. Unlike the hypothetical involving corporation to shareholder loans, shareholder to corporation loans can theoretically be dealt with adequately under section 482 (or section 61). Again using the historical 46% corporate rate and the 50% individual rate, assume that C, an individual involved in a related trade or business, makes a loan of $100,000 to his wholly owned subsidiary, Z. If, pursuant to the <u>Latham Park Manor</u> decision, the Service makes an allocation under section 482 to impute an arm's length interest rate of 10% on that loan, C is treated as earning $10,000 of interest income and pays a tax of $5,000. Z is allowed an interest deduction of $10,000 and is thereby able to shelter $10,000 of income resulting in a tax benefit of $4,600. If, after an adjustment under section 482, C chose to leave the $10,000 in Z, this amount would automatically be treated as a contribution to capital since there would be no further tax consequences and such treatment would be beneficial to the taxpayer.

In the corporation to shareholder loan, a loan and a dividend are in effect compressed into a single transaction. Both have tax consequences that must be accounted for. In the case of a loan from a shareholder to a corporation, a loan and a contribution to capital are compressed into a single transaction. Since the contribution to capital has no immediate tax consequences, the result reached under section 482 is exactly the same as under section 7872, unless circumstances would indicate an arm's length interest rate different from the applicable federal rate as defined in section 1274(d).

The provisions of section 7872 are mandatory and apply to all loans within the specified categories. However, section 7872(h) provides the Secretary with the authority to issue regulations as may be necessary to carry out the purposes of this section, to ensure that the borrower and the lender take consistent positions and to exempt transactions from the application of the section which have no significant effect on any federal tax liability. Pursuant to this authority, the Secretary has issued Temporary Reg. 1.7872-5T which exempts certain categories of loans from the application of section 7872. Treas. Reg. 1.7872-5T(b)(10), as amplified by Treas. Reg. 1.7872-5T(c)(2) exempts loans from foreign persons to U.S. persons except in certain limited situations not applicable herein. A further exception exists in Treas. Reg. 1.7872-5T(a)(2) which provides that a transaction is not eligible for exemption, regardless of form, if one of the principal purposes of the transaction was to avoid federal tax.

Whether paid to a foreign individual or foreign corporation, non-portfolio interest from U.S. sources is taxed at a flat 30% rate if it is not effectively connected to the conduct of a U.S. trade or business. Under many of our tax treaties, the 30% rate is reduced to 5% or 10%. Since section 7872 is mandatory except as provided in regulations, controlled U.S. corporations would have been able to effectively secure a deduction for their dividends by structuring the transaction as an interest-free loan instead of a dividend. When the top corporate tax rate was 46%, this would have created a very substantial tax avoidance incentive even if the withholding tax was computed at the full 30% rate. Based on the broad regulatory authority granted to the Commissioner to adapt the provisions of section 7872 to effect the purposes of the law, we think that the criticism in the Price Waterhouse International Tax Review article is not well taken. Clearly, section 7872 was intended to close loopholes, not to create them.

Accordingly, we think that exemption of inbound loans from foreign persons to U.S. persons is a proper exercise of the broad regulatory authority granted to the Secretary and that any application of section 7872 to such loans must be made on the basis of a tax avoidance motive. Generally, such a motive will not exist since the result of not charging interest to the U.S. person is to reduce the deductions available to the U.S. person and thereby increase U.S. income. Obviously, there may still be situations where the deduction generated by the interest charged to the U.S. person could not be utilized by the U.S. person, or at least could not be utilized currently. Under such circumstances, a tax avoidance motive can still exist. If you do encounter such a circumstance, we see no reason why section 7872 cannot be applied. However, we believe that a court would not be willing to presume a tax avoidance motive from the mere fact that no tax was paid. Some additional evidence of motive will be necessary. We further believe that section 482 would similarly be applicable in such circumstances but for proposed Treas. Reg. 1.7872-2(a)(2)(iii) which provides that where section 7872 and section 482 both apply to a transaction, section 7872 is to be applied first. As previously discussed, the result reached under section 7872 will be exactly the same as that which would be reached under section 482 unless there are indications that an arm's length interest charge would be greater than the applicable federal rate. While section 7872 may be applied in limited circumstances, we question whether there will be many situations in which it should be applied. In return for a current tax at a maximum 30% rate, an adjustment under section 7872 potentially raises the possibility that a U.S. corporation will later receive a 34% benefit. In our experience, it will generally be more productive to question why these controlled U.S. corporations are not profitable. Often, it is due to overcharges by the foreign shareholder for goods and services.

With respect to your second question as to whether the U.S. borrower must currently withhold tax under sections 1441 and 1442 on imputed interest, we concur in your conclusion that section 7872(a)(2) treats foregone interest as having been transferred and retransferred on the last day of the calendar year in which the transaction transpired, and further, the deemed transfer would constitute payment for purposes of sections 1441 and 1442 and Treas. Reg. 1.1441-1. From the language and the context of the statute, it is clear that Congress intended that the constructive transfer and retransfer of the foregone interest be treated in the same manner as if an actual transfer and re-transfer had occurred. As you note in your memorandum, it is not absolutely clear as to whether withholding could be required on interest imputed under section 482 in the absence of actual payment. Under sections 871 and 881, the tax on fixed or determinable income is levied on amounts "received" from United States sources. Treas. Reg. 1.1441-1 correspondingly requires that the tax be withheld when amounts constituting income from U.S. sources are "paid" to a foreign person. In effect, we read these provisions as placing all foreign recipients of non-effectively connected fixed or determinable income on a cash method of accounting for U.S. tax purposes. Thus, payment is normally a prerequisite to U.S. tax liability. However, with respect to related parties, we believe that in appropriate circumstances, a viable argument can be made that there has been constructive receipt or payment of U.S. source income. In other words, the recipient exercises its right to receive the income by choosing to leave it with the related party. In any event, we think it unnecessary to answer this question at this time since we have concluded that section 7872 applies and that the deemed transfer constitutes payment for purposes of sections 1441 and 1442.

(Signed) Michael F. Patton

MICHAEL F. PATTON